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No. 87-1168

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In the Supreme Court of the United States

OCTOBER TERM, 1988

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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1. In our opening brief, we argued that the distribution of cash to respondent, in the course of a merger of his wholly-owned corporation (Basin) into a subsidiary of a larger corporation (NL), had "the effect of the distribution of a dividend" within the meaning of Section 356(a)(2) of the Code. We explained that the distribution of boot on a pro rata basis to the shareholders of the acquired corporation (in this case, to the sole shareholder of Basin) has all the earmarks of a classic dividend, to the extent of the corporation's accumulated earnings and profits (see Gov't Br. 15-27). We also explained that the court of appeals' holding that "the boot should be characterized as a post-reorganization stock redemption by N.L. [of stock hypothetically received in a pure stock-for-stock reorganization]" (Pet. App. 7a), which gives respondent the tax treatment of the transaction that he specifically declined to consummate, cannot be reconciled with the terms of the statute and is mistaken on several counts (Gov't Br. 27-39).

Respondents' general response to our argument is the assertion that only the result reached by the court of appeals is faithful to the "reality of the situation" (Resp. Br. 4). The objection to our argument is couched in various phrases. Respondents claim that the courts below decided the case in the "realistic" (Br. 9, 17, 25 n.24) context of the "overall" (Br. 8, 13, 15, 16) or "integrated" (Br. 6, 7, 8, 9, 16) transaction; the government, on the other hand, "bifurcate[s]" (Br. 7, 16) the transaction "artificial[ly]" (Br. 16, 17, 24, 25) by viewing the distribution of the cash "in isolation" (Br. 4, 8, 13, 25). Respondents' argument appears to be summarized in the following passage (Br. 9-10 (emphasis in original)): the case can be decided "only by considering the effect of the exchange in the context of the transaction *as a whole,* as the courts below did, not as if the cash had been received in isolation, as the petitioner would have this Court do." Respondents' argument completely misses the mark. The government's analysis fully comports with the text of the statute. It is respondents' analysis, which pretends that the boot was distributed in a hypothetical post-reorganization redemption of shares that were never owned by respondent, that "artificially bifurcates" the overall transaction.

It is undisputed that the boot distribution here took place in the course of the reorganization—not before or after it. Thus, it was not a direct distribution of property from a corporation to its stockholders as could occur outside a reorganization—*i.e.,* it was not a "dividend" as defined in Section 316 of the Code.[1] But Section 356(a)(2)

[1] The entire merger transaction took place on one day, April 18, 1979, and its elements were for all practical purposes simultaneous. Accordingly, the "step transaction doctrine," which respondents rely upon and criticize the government for not mentioning (see Resp. Br. 14-16 & n.10), is inapplicable here. That doctrine examines a series of apparently separate transactions to determine whether they should be treated as a unified transaction.

asks whether this distribution had "the effect of the distribution of a dividend," and thus it explicitly channels the inquiry towards a comparison with the effect of a direct distribution of cash to the shareholders of a single corporation. Therefore, to the extent the government's comparison of the boot distribution with a dividend (*i.e.,* with a pro rata payment outside the context of a reorganization) views "the cash * * * in isolation" (Resp. Br. 4), that is what the statute demands.[2] And, if the transaction has "the effect of the distribution of a dividend," it is irrelevant under the statute whether, seen from another angle, it can be said to resemble some other transaction, such as a redemption that is not essentially equivalent to a dividend (see Gov't Br. 37). The approach of the courts below, by contrast, lacks a statutory basis; it "artificially bifurcates" (see Resp. Br. 16) the merger transaction into a reorganization and a "post-reorganization stock redemption" (Pet. App. 7a).[3]

[2] Moreover, because the statute establishes that the amount of any dividend is to be measured by the earnings and profits of the acquired corporation (see Gov't Br. 34-35), it channels the inquiry towards a comparison with a distribution by that corporation, whose shareholders are the ones in a position to take advantage of a possible bail-out of earnings and profits in the course of the reorganization.

[3] Although respondents studiously avoid referring to their approach as hypothesizing a post-reorganization redemption, it is apparent that their analysis is no different from that of the court of appeals. Respondents explain that there was no dividend here because the consequence of the exchange was that respondent "had a significantly smaller ownership interest in the continuing enterprise—by some 30 percent—than he would otherwise have had if the exchange had involved entirely NL stock" (Br. 13 (footnote omitted)). They further state that respondent's interest in the surviving corporation "was diminished by reason of having received" the boot (Br. 25) and that the effect of the distribution was respondent's " 'relinquishment of a portion of his interest in the newly reorganized

A simple examination of the change in respondent's ownership interest "in the context of the transaction *as a whole*" (Resp. Br. 9-10 (emphasis in original)), which is the yardstick that respondents purport to be using, clearly shows that respondents in fact are not looking at the overall transaction; moreover, it demonstrates the complete unsuitability of making Section 356(a)(2) determinations by means of a blind application of Section 302 principles to a hypothetical redemption. The "minnow-whale" reorganization that occurred here, regardless of its precise details, was intended to transform respondent from the sole shareholder of Basin to the holder of a small percentage of shares in the continuing enterprise. If respondent had accepted the pure stock-for-stock option, his interest in the continuing enterprise would have gone from 100% in Basin to 1.3% in NL. It is undisputed that this enormous reduction in respondent's interest and loss of control would have been viewed as an ordinary incident of the reorganization and not considered in determining whether dividend treatment is appropriate (see Pet. App. 13a; Br. in Opp. 15 n.18; Resp. Br. 41-42; see generally Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2),* 39 Tax L. Rev. 297, 325-326 (1984)). The position of the courts below, however, is that the

corporation' " (Br. 14 (quoting Pet. App. 2a)). Of course, there was no actual diminution or relinquishment of any interest of respondent's in NL either in the course of the reorganization or afterwards. He had never previously held any more than the 300,000 shares of NL stock that he held after the reorganization was completed. One can speak of a diminution or relinquishment of respondent's interest in NL—and apply to that diminution the standards of Section 302 (see Resp. Br. 13 n.8, 18-23)—only if one hypothesizes that respondent received 425,000 shares of NL in a stock-for-stock reorganization and then subsequently redeemed 125,000 of those shares in exchange for the amount of the boot.

slightly greater reduction of interest that actually occurred here as a result of the reorganization involving boot, from 100% ownership to 0.92%, is inconsistent with dividend treatment because it is a "meaningful reduction" in interest (Resp. Br. 9). Plainly, this result derives not from examination of the "overall transaction," but rather from viewing receipt of "the cash * * * in isolation" in a hypothetical post-merger redemption.

Congress clearly was aware when it enacted Section 356(a)(2) that a reorganization likely will involve a reshuffling of shareholder interests and the loss of some degree of corporate control. It was also aware that, when boot is distributed in the reorganization, the shareholders of the acquired corporation inevitably will be left with a smaller interest in the continuing enterprise than they would if the reorganization were purely stock-for-stock. Congress did not view that fact as inconsistent with dividend treatment of boot, however, and it established as the test an inquiry into whether the boot distributed in the course of the reorganization has the same effect as the distribution of a dividend that would occur outside the reorganization. This test is perfectly sensible and does not fail to account for the difference in post-reorganization corporate control between the two options. After all, if the acquired corporation directly distributed a dividend to its shareholders as part of the overall transaction, the shareholders obviously would obtain a smaller interest in the continuing enterprise than if the dividend had not been distributed; that fact, however, would not prevent the payment from being taxed as a dividend. See pages 7-9, *infra*.[4]

[4] That respondents' approach depends upon "artificially bifurcating" the transaction is also illustrated by the fact that respondents would apply to the hypothetical reduction in corporate interest computed under their theory Revenue Rulings holding that "even a quite small reduction in the interest of a minority shareholder" may pre-

2. At some points in their brief, respondents appear to suggest that the transaction should be viewed as a *sale* of part of respondent's interest in Basin for cash and a stock-for-stock exchange for the remainder. See Resp. Br. 9, 19, 28-29. As we noted in our opening brief (at 19 n.11), however, treating the transaction as a sale is flatly inconsistent with the fact that it was a reorganization under the Code; reorganization treatment, on the theory that the transaction was merely a reshuffling of interests in a continuing enterprise, conferred substantial tax benefits upon respondent. If the transaction that occurred here had been a *sale,* the more than $10 million of gain realized by respondent on the merger (see Gov't Br. 4 n.4) would all have been taxable; instead, under the reorganization provisions, respondent was not required to recognize and pay tax on the gain except to the extent of the $3,250,000 in cash that he received. Respondents cannot have it both ways. Under the continuing enterprise premise that justifies nonrecognition treatment, the boot payment must be regarded not as a purchase, but as a distribution by a corporation to its shareholders that can have the effect of a dividend.

3. Respondents object (Br. 17, 26, 28) that the boot payment cannot be characterized as a dividend in the

clude dividend treatment (see Resp. Br. 33 n.36). Those rulings are premised in large part, however, on the practicalities of being a minority shareholder; he "exercises no control over [corporate] affairs" and hence lacks the power to use a redemption to disguise a dividend. Rev. Rul. 76-385, 1976-2 C.B. 92, 93; see also S. Rep. 1622, 83d Cong., 2d Sess. 44 (1954). That rationale can apply here only if one focuses exclusively on the hypothetical post-reorganization redemption; if one looks at the "overall" transaction, respondent exercised complete control over the affairs of his corporation and surely had the power to issue a dividend or otherwise control the form in which Basin's earnings were distributed to him.

amount of Basin's accumulated earnings and profits because Basin's financial condition before the reorganization was not sufficiently liquid to have allowed it to make a cash distribution in that amount.[5] That objection is unsound for two reasons. First, the liquidity problem would not necessarily have prevented Basin from declaring a dividend. It could have distributed a dividend in the form of its own obligation (see, *e.g.*, I.R.C. § 312(a)(2)) or it could have borrowed funds to distribute a dividend. More fundamentally, however, respondents' objection is irrelevant because Section 356(a)(2) does not ask whether the boot distribution was in actuality a dividend issued by the acquired corporation; rather, it asks whether the boot had "the effect of the distribution of a dividend." Accordingly, as we noted in our opening brief (at 23), it was repeatedly recognized in the established line of authority treating pro rata boot distributions as dividends that it is immaterial to that determination whether the acquired or the acquiring corporation actually pays out the cash to the shareholders. See, *e.g.*, *Commissioner* v. *Owens,* 69 F.2d 597, 598 (5th Cir. 1934); *Ross* v. *United States,* 173 F. Supp. 793, 798 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959).

The facts of one of the landmark reorganization cases decided by this Court, *Helvering* v. *Minnesota Tea Co.,* 296 U.S. 378 (1935), which closely parallel those in this case, well illustrate that the boot distribution in this case had the "effect of the distribution of a dividend." That case involved a corporate transaction in which Minnesota

[5] Although respondents state that the amount of the boot distribution exceeded not only Basin's cash, but also its net assets (see Br. 17, 26, 28), it has never been contended that the entire amount of the boot distribution should be treated as a dividend. Rather, dividend treatment is limited to an amount equal to Basin's accumulated earnings and profits, which concededly did not exceed its net assets (see Resp. Br. 26).

Tea transferred all of its assets to the Grand Union Company in exchange for 18,000 shares of Grand Union stock and $426,842 in cash. The cash was immediately distributed by Minnesota Tea on a pro rata basis to its three stockholders. 296 U.S. at 381-382. This transaction gave rise to considerable litigation over whether it was a reorganization (see 296 U.S. 378 (1935) (holding that it was)) and over the extent of Minnesota Tea's allowable deductions (see 302 U.S. 609 (1938)). It was agreed by all, however, that the cash payment was taxable as a dividend to the shareholders to the extent of their ratable share of Minnesota Tea's earnings and profits, and they so reported the cash payment on their tax returns. The conclusion that these payments were dividends, of course, followed directly from the predecessor of Section 316 of the Code since the cash was a pro rata distribution paid by Minnesota Tea to its shareholders.

The facts of *Minnesota Tea* are almost exactly parallel to those of this case. In both cases, the boot for the reorganization was paid by the acquiring corporation and, applying the approach of the court below, the shareholders' interest in the continuing enterprise was significantly reduced as compared to what it would have been had there been a pure stock-for-assets reorganization, without boot.[6] The only difference is in the form of

[6] If the boot received by the shareholders of Minnesota Tea is converted to stock at its approximate market value of $30/share (see 28 B.T.A. 591, 592 (1933)), the actual reorganization with boot yielded a 44% reduction from the interest that the shareholders would have held in Grand Union under a hypothetical pure stock-for-assets reorganization, without boot. In this case, the analogous diminution of interest was 30% (see Resp. Br. 13). Moreover, as in this case, Minnesota Tea lacked the liquidity to pay a dividend out of its own funds; in fact, part of the transaction was that the shareholders would use the cash they received in the reorganization to satisfy more than $100,000 of the corporation's debts (296 U.S. at 381).

the reorganization. This case involves a statutory merger in which the acquired corporation ceases to exist as an independent entity; *Minnesota Tea* involved a transfer of assets, which would now be classed as a "C" reorganizaton (I.R.C. § 368(a)(1)(C)), in which the "acquired" corporation retains its existence as a "shell." Because of that difference, respondent's ownership interest after the reorganization was reflected in direct ownership of NL stock; in *Minnesota Tea,* the shareholders' interest was reflected in ownership of shares in a "shell" corporation, which owned nothing but shares in Grand Union, the continuing enterprise. This difference in the form of ownership is irrelevant, however, with respect to a comparison of interests in the continuing enterprise or any other policy relevant to Section 356(a)(2). Accordingly, if the boot distribution in *Minnesota Tea* was a dividend—and there is no basis for disputing that it was—the closely analogous boot distribution in this case must have had "the effect of the distribution of a dividend."

4. Respondents assert (Br. 20 n.18) that Congress's action in 1984 in amending Section 356(a)(2) to apply to it the attribution rules of Section 318 of the Code demonstrates the correctness of their argument that Section 302 redemption principles must be used to determine dividend equivalency under Section 356. "Unless the section 302 test of a change in ownership interest were to be applied for section 356(a)(2) purposes," respondents argue (Br. 21 n.18), "there would be no need for an attribution rule to compute such ownership interests." This argument is clearly mistaken; the attribution rules are as relevant under the government's approach as they are under respondents' approach. Suppose, for example, that A owned 30% of the stock of a corporation acquired in a merger and B owned the other 70%. If A received only cash on the merger and B received shares of the acquiring

corporation, it would seem clear that the payment to A would not have the effect of a dividend under Section 356(a)(2) since it not only was not pro rata, but also completely terminated A's interest in the continuing enterprise. But if it develops that A and B are father and son, which means that their respective stock ownership interests must be attributed to each other under Section 318, then the boot distribution becomes pro rata to a sole shareholder and should be treated as a dividend. Thus, the relevance of the attribution rules of Section 318 does not turn on any reference to Section 302.

5. As we noted in our opening brief (at 20), the legislative history of the predecessor of Section 356(a)(2) suggests that Congress wanted to provide dividend treatment when the effect of the receipt of the boot is "the same as if the corporation had declared out as a dividend its * * * earnings and profits" (H.R. Rep. 179, 68th Cong., 1st Sess. 15 (1924)), as is the case here. Respondents maintain, however, that this legislative history counsels rejection of the government's position because the example given by Congress shows that it was concerned about abuse where "a *single* corporation reincorporated in a transaction which qualified as a reorganization" (Resp. Br. 33 (emphasis in original)). Clearly, Congress did not intend to restrict the application of Section 356(a)(2) to such cases. The situation described in the committee reports was put forth as an example and was not intended to be exclusive. If Congress had sought to limit the application of Section 356(a)(2) in the manner suggested by respondents, it could easily have accomplished that goal in the statute itself by limiting its application to "D" reorganizations (I.R.C. § 368(a)(1)(D)). It did not do so, and therefore Section 356(a)(2), together with its underlying purposes as reflected in its legislative history, is fully applicable to reorganizations such as the one in this case that do not involve only a single corporation.

6. Respondents state that "leading scholars and commentators" (Br. 23), as well as the Treasury Department, agree with the result below and "have dismissed [the contrary decision in] *Shimberg* [v. *United States*, 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979),] as a sport" (Resp. Br. 39). As we stated in our reply at the petition stage (at 3, 6-8), this extravagant assertion is without foundation. First, the "leading scholars and commentators" cited by respondents (Br. 23 n.22) primarily are private attorneys writing in practitioners' journals; it is hardly surprising that they take a position supporting capital gain treatment, which is generally favorable for their clients. Several scholars approaching the issue from a more disinterested perspective, however, have recognized that boot distributions made on a pro rata basis to the shareholders of the acquired corporation should be treated as dividends under Section 356(a)(2) (see, *e.g.*, Gov't Br. 19, 21, 25 n.13).

With respect to respondents' suggestion that Congress and the Treasury Department have embraced the result below, we explained in detail in our reply at the petition stage (at 6-8) that respondents have misinterpreted the significance of the Treasury Department's comments on the recent proposals to revise Subchapter C of the Internal Revenue Code, which were never enacted. Though it viewed the question as a "close call," the Treasury Department stated that, "[o]n balance," it did not oppose a provision that would have codified the result below, "in the context of the overall project," which contained other changes that would have relaxed existing limitations on the amount of boot dividends. See *Reform of Corporate Taxation: Hearing Before the Senate Comm. on Finance*, 98th Cong., 1st Sess. 24-25 (1983); Gov't Reply Br. 6 & n.5. This comment did not declare the result below to be good policy, and it certainly did not acknowledge it as a correct

construction of existing law. On the contrary, to the extent that the Treasury Department's comments addressed the meaning of the existing version of Section 356(a)(2), they indicated a preference for the *Shimberg* case that is contrary to the decision below.

Nor can it reasonably be said that Congress has "dismissed *Shimberg* as a sport" (Resp. Br. 38-39) simply because the most recent Senate proposal to restructure Subchapter C would have codified the result below—among many other changes. As the Tax Court noted (Pet. App. 30a n.9), there have been numerous proposals at various times to amend the Code to address "boot dividends" more explicitly, some of which would have specifically rejected the result below. For example, the House version of the 1954 Code applied numerical disproportionate distribution criteria to boot distributions, but it also expressly provided that the criteria would apply with reference to the "shareholders of the corporation in which the shareholder held stock immediately prior to the transaction" (see H.R. 8300, 83d Cong., 2d Sess. § 306 (1954)). Therefore, pro rata payments to the shareholders of the acquired corporation would have "the effect of the distribution of a dividend" to those shareholders, to the extent of the corporation's earnings and profits. See H.R. Rep. 1337, 83d Cong., 2d Sess. A85-A86 (1954). A distinguished advisory group appointed by the House to study Subchapter C made a similar recommendation in 1958, noting that the test of disproportionateness should be applied to the shareholders of the acquired corporation, "not by reference to the percentage holdings in the transferee corporation as a whole." See *Revised Report on Corporate Distributions and Adjustments to Accompany Subchapter C Advisory Group Proposed Amendments, as Revised* 68-69 (GPO Dec. 11, 1958). What is significant is that

Congress has never enacted any of these proposed major revisions of the statutory framework. Instead it has left the characterization of boot distributions to be governed by the longstanding rule of Section 356(a)(2), which the great weight of authority has construed for 50 years to require dividend treatment for boot distributions made on a pro rata basis to the shareholders of the acquired corporation (see Gov't Br. 21-27).

For the foregoing reasons, and those stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

CHARLES FRIED
Solicitor General

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